DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 98-0035 ITC
GROSS INCOME TAX
For Years 1991, 1992, AND 1993

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ISSUES

I. **Adjusted Gross Income Tax**– Business Income

Authority: 45 IAC 3.1-1-29; 45 IAC 3.1-1-41(4); 45 IAC 3.1-1-60(6); IC § 6-3-1-20; IC § 6-3-1-21; *Allied-Signal Inc. v. Director Div. of Taxation,* 112 S. Ct. 2251 (1992)

Taxpayer protests the proposed classification of nonbusiness income as business income.

II. **Adjusted Gross Income Tax**– Deconsolidation

Authority: 45 IAC 3.1-1-110; 45 IAC 3.1-1-111; 45 IAC 3.1-1-8; IC § 6-3-3-14; 45 IAC 3.1-1-38; 45 IAC 3.1-1-42; IC § 6-3-4-14; *Wisconsin Department of Revenue v. Wrigley*, 112 S. Ct. 2447, (1992); *Wabash, Inc., v. Department of State Revenue*, 729 N.E. 2d 620 (Ind. Tax Court 2000); *Department of Revenue v. Kimberly-Clark Co.*, 275 Ind. 378, 416 N.E.2d 1264, 1268 (1981)

Taxpayer protests the proposed deconsolidation of taxpayer's Indiana filing.

III. **Adjusted Gross Income Tax**– Sales factor reduction for out-of-state sales.

Authority: 45 IAC 3.1-1-64; IC § 6-3-2(e)(2); *First Chicago NBD Corp. v. Department of State Revenue*, 708 N.E.2d 631 (Ind. Tax Court 1999)

Taxpayer requests sales factor reduction for out-of-state sales.

IV. **Adjusted Gross Income Tax**– Indiana Research Expense Credit.

Authority: IC § 6-3.1-4

Taxpayer protests the denial of the Indiana research expense credit.

V. **Adjusted Gross Income Tax**– Negligence Penalty

Authority: 45 IAC 15-11-2; IC § 6-8.1-10

Taxpayer protests the imposition of a negligence penalty.

STATEMENT OF FACTS

Taxpayer is a publicly held, multistate corporation organized under the laws of Delaware, with its corporate headquarters in New York. It is a research based global health care company whose main areas of operation are the development, manufacture, and sale of pharmaceuticals, animal health products, and consumer health and over-the-counter medications.

In the early 1990's, Taxpayer sought to refocus on its core health care businesses. Accordingly, in 1992, the company reorganized its specialty minerals business, which was not involved in health care, so that the business could be sold. In that reorganization, Taxpayer contributed the assets of its specialty minerals business to a new corporation, a wholly owned subsidiary. As so constituted, the new corporation was a company that developed, produced, and marketed world-wide a broad range of specialty mineral, mineral based, and synthetic mineral products used in the paper, steel, building materials, polymers, ceramics, paints and coatings, and glass industries.

In October 1992, Taxpayer sold approximately 60% of its stock in the new corporation through an initial public offering. After the offering, the stock of the new corporation was publicly held and listed on the New York Stock Exchange. The status of the initial public offering is not at issue inasmuch as taxpayer treated this income as business income. Because of poor market conditions at the time of the initial public offering, taxpayer retained 40% of the new corporation stock with the hope that market conditions would improve. The market did improve, and six months after the initial public offering, taxpayer had the opportunity to make a significant profit on the sale of its remaining interest in the new corporation. In April 1993, taxpayer sold its remaining 40% interest in the stock of the new corporation. On its Indiana income tax return, taxpayer treated the gain on the stock as nonbusiness income. However, the auditor included the gain as part of taxpayer's business income, and assessed a deficiency for that year.

I. Adjusted Gross Income Tax– Business Income

DISCUSSSION

"Business income" and "nonbusiness income" are defined by the Indiana Code as follows:

> Sec. 20. The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.
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> Sec. 21. The term "nonbusiness income" means all income other than business income. IC § 6-3-1-20 and 6-3-1-21.

The terms are similarly defined by the Indiana Administrative Code:

> Sec. 29. "Business Income" Defined. "Business Income" is defined in the Act as income from transactions and activity in the regular course of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business.
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> Nonbusiness income means all income other than business income.
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> The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business. 45 IAC 3.1-1-29.

At one time, the specialty minerals business was a division of taxpayer, was managed by taxpayer's Board of Directors, and was an integral part of taxpayer's regular trade or business. However, taxpayer's Board of Directors adopted a policy of divestiture to enable the company to focus on its core health-care business. As a result, taxpayer transferred all of its specialty minerals business to the newly formed corporation.

After taxpayer established the new corporation as a separately incorporated enterprise, taxpayer sold a majority of the new corporation stock in 1992 through an initial public offering. In 1993, when taxpayer liquidated its remaining interest in the new corporation, it was a minority stockholder in a publicly traded company. From that point forward, taxpayer argues it was no

longer in the specialty minerals business and it was not in the regular business of buying, holding, or selling the stock of other corporations. Taxpayer maintains that the taxpayer was "simply a minority stockholder" and that the taxpayer is not in the business of selling stock.

Taxpayer favorably compares its situation to the following illustration from the Indiana Administrative Code describing when property should be removed from the property factor:

> (4) The taxpayer ceases to operate one of the divisions of its business, but holds part of the property of such division solely for investment purposes. It does not thereafter use the property in the regular course of business. At the time the property is converted to investment property, it is removed from the property factor. Any income from the use of the property as an investment is nonbusiness income. 45 IAC 3.1-1-41(4).

Taxpayer notes that its new corporation was segregated not merely as a separate division of taxpayer, but as an entirely separate, stand-alone corporation. Taxpayer argues that it retained a minority stock interest in the new corporation solely as an investment and not as a part of taxpayer's regular business.

Taxpayer then cites as analogous another illustration in the Indiana Administrative Code describing when dividends are considered to be nonbusiness income:

> (6) The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock for investment purposes, the acquisition and holding of which are unrelated to the manufacturing business. The dividends received are nonbusiness income. 45 IAC 3.1-1-60(6).

45 IAC 3.1-1-60 is relevant to this fact pattern, unlike 45 IAC 3.1-1-41, which deals with situations where property will be removed from the property factor calculation. 45 IAC 3.1-1-60, which deals with nonbusiness income, states in relevant part:

> Dividends. Dividends are nonbusiness income if the stock with respect to which the dividends are received did not arise out of or was not acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is not related to or incidental to such trade or business operation.

While neither regulation directly discusses the stock sales situation at issue, the classification of the income from the stock is made contingent on the underlying circumstances behind the acquisition of the stock by taxpayer.

In *Allied-Signal Inc. v. Director Div. of Taxation*, 112 S. Ct. 2251 (1992), the U.S. Supreme Court recognized that in some limited instances, a transaction that serves an operational function may be apportioned even though the parties to the transaction are not engaged in the same unitary business. The *Allied-Signal* case explained that "stock investments" may be apportionable as operational activities if they constitute "interim uses of idle funds 'accumulated for the future operations of [the taxpayer's] . . . business [operation],'. . ." *Id.* at 2263 quoting

Asarco, 102 S. Ct. at 3133 n. 21. The Court also stated that a capital transaction may be considered an operational function rather than an investment function if it "amounted to a short-term investment of working capital analogous to a bank account or certificate of deposit." *Allied-Signal*, 112 S. Ct. at 2264.

Similarly, taxpayer's minority interest in the new corporation stock was a short-term investment of working capital analogous to a bank account or certificate of deposit. The October 22, 1992 minutes of the taxpayer Board indicate that the decision to retain a minority interest in the new corporation stock was simply an interim use of idle funds:

> . . . due to weakening market conditions and other factors a majority of the outstanding shares could not be sold at the minimum price of $18 per share set by the Board. *[Speaker] reviewed the situation and compared a sale of a majority of the outstanding shares at $16 per share with other alternatives, including retaining 100% of the business*. He noted that for both financial reasons as well as considerations of morale of the employees in this business and the commitment of management time to it that would be required he would recommend that the Board grant authority to the Pricing Committee to agree to the sale of a majority of [the new corporation] shares at a minimum price of $16 per share or at least 60% of [the new corporation] shares at a minimum price of $15.50 per share . . .. They discussed the fact that a substantial minority of the shares are being retained which provides the Company with the possibility of appreciation in value should the business continue to grow and prosper. *(Emphasis added)*

The original nature of the stock acquisition was, ultimately, to sell 100% of these business assets. While 40% of the stock was briefly retained, and then sold for a profit, the underlying transaction focused on divestiture of the business, not investment.

As taxpayer correctly determined in its initial sale of stock, the stock was sold to divest taxpayer of the business. Sixty percent of the stock was sold immediately. This resulted in proceeds from stock acquired as part of its business operations which were treated as business income by taxpayer. The determination by the board to retain the remaining 40% of the stock and delay the final sale of the remaining stock until a more favorable price could be obtained did not establish an investment function as the underlying circumstances behind the ***acquisition*** of this stock and taxpayer's retention of the 40% share for only six months is too short a time period- especially given taxpayer's motivation for creating/acquiring such stock-to warrant characterization of the sale proceeds as passive nonbusiness investment income. The remainder of the proceeds from this transaction must be classified as business income.

FINDINGS

Taxpayer protest is denied.

II. Adjusted Gross Income Tax– Deconsolidation

DISCUSSSION

Subsidiary was a wholly owned division of taxpayer that distributed blood monitoring equipment and supplies in Indiana and other states. Subsidiary was registered to do business in Indiana during the audit period. Pursuant to Indiana Code 6-3-3-14, taxpayer elected to file consolidated returns for its affiliated group of corporations, including subsidiary. 45 IAC 3.1-1-110 then required taxpayer to continue filing on a consolidated basis unless taxpayer requested and received permission from the department to file otherwise. The auditor deconsolidated subsidiary for the 1993 report year, stating: "The company had at the end of 1993 no property in Indiana, a nominal $1,000 in inventory, no rent or Indiana payroll and a nominal interstate sales to Indiana of $25,953." The auditor concluded that subsidiary; "lacks Indiana adjusted gross income and nexus."

The Indiana Code authorizes an affiliated group of corporations to file a consolidated return provided that each corporation has adjusted gross income derived from sources within Indiana:

> (a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC § 6-3. . . .
>
> (b) For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group *shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana*. IC § 6-3-4-14 (emphasis added).

The Indiana Administrative Code further clarifies that "adjusted gross income" may include income or losses:

> Sec. 111. Affiliated Group. The Adjusted Gross Income Tax Act adopts the definition of "affiliated group" contained in Internal Revenue Code section 1504, except that no member of the affiliated group may be included in the Indiana return unless it has adjusted gross income derived from sources within the state, as that phrase is defined in IC § 6-3-2-2. For purposes of this subsection, "Adjusted Gross Income derived from sources within the state" means either *income or losses* derived from activities within the state. 45 IAC 3.1-1-111 (emphasis added).

The auditor cited 45 IAC 3.1-1-8, which provides that "adjusted gross income" is determined by subtracting income exempt from tax under the Constitution and statutes of the United States. Thus, the return for 1993 was deconsolidated because subsidiary "lacks Indiana adjusted gross income and nexus" for that year, and-presumably-was exempt from Indiana taxes under the Constitution and statutes of the United States.

If subsidiary was "doing business" in the State, it was not exempt from tax under the Constitution and statutes of the United States, and it was eligible for consolidation. The Indiana Administrative Code includes the following examples of doing business in the State:

> (1) Maintenance of an office or other place of business in the state.

(2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods

(3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution

(4) Rendering services to customers in the state

(5) Ownership, rental or operation of a business or of property (real or personal) in the state

(6) Acceptance of orders in the state

(7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income. 45 IAC 3.1-1-38.

The record shows that subsidiary had property valued at $2,350 at the beginning of 1993 and $1,000 at the end of 1993. The United States Supreme Court has held that "a stock of gum worth several thousand dollars" was nontrivial. *Wisconsin Department of Revenue v. Wrigley,* 112 S. Ct. 2447, 2460 (1992). Subsidiary had Indiana sales of $23,953. Indiana sales represent almost two percent of subsidiary's total sales.

Subsidiary's sales representatives in Indiana, in addition to soliciting sales, serviced and calibrated the blood monitoring equipment and trained hospital personnel on the use of the equipment. The United States Supreme Court has held that "employing salesmen to repair or service the company's products" will create nexus. *Id*. at 2457.

As was noted in *Wabash, Inc., v. Department of State Revenue*, 729 N.E. 2d 620 (Ind. Tax Court 2000) pg. 624; "The Indiana Supreme Court has stated that particular emphasis should be placed upon the totality of the business activities of a company within Indiana when interpreting PL 86-272. See *Department of Revenue v. Kimberly-Clark Co*., 275 Ind. 378, 416 N.E.2d 1264, 1268 (1981)." The following table illustrates taxpayer's subsidiary's activities in the State in the surrounding years, which created nexus in those years, and as the tax court noted in Wabash, is relevant as to the totality of business activity by the subsidiary.

	1991	**1992**	**1993**	**1994**	**1995**
Payroll	$264,785	$109,454	0	$40,158	$34,000
Tangible Property-Beginning Balance	$30,577	$16,947	$2,350	$1,000	$13,450
Tangible Property-Ending Balance	$16,947	$2,350	$1,000	$13,450	0
Sales	$1,378,523	$256,786	$25,953	$24,062	$9,320

The consolidated reporting of subsidiary for all the audit years follows the Department's policy of consistent reporting from year to year. See 45 IAC 3.1-1-42 (consistency among reports).

Subsidiary was doing business in the State during 1993, its income was apportionable to the State, and it qualified for the consolidated tax return.

When the subsidiary is included in the consolidated return, the issue of apportionment is raised. Taxpayer would apportion the income using the standard three factor apportionment formula, while the Department advocates, citing IAC 45-3.1-1-39, using a stacked method to compute the taxes— computing the subsidiary's income separately from the remainder of the taxpayer's return. In *Wabash, Inc., v. Department of State Revenue*, 729 N.E. 2d 620 (Ind. Tax Court 2000), the court, in rejecting the stacked method, notes "The spirit and intent of a consolidated adjusted gross income tax return is to treat an affiliated group as a single taxpayer. (Cite omitted)" pg. 626. The court also notes that "Having raised this issue, the Department bears the burden of proving that Wabash's Indiana income does not fairly reflect Indiana-sourced income." pg. 624. Consistent with the Court's and the Department's preference for using the standard three factor apportionment formula, such methodology should be used by taxpayer in computing its Indiana Adjusted Gross Income.

FINDINGS

Taxpayer protest sustained.

III. Adjusted Gross Income Tax– Sales factor reduction for out-of-state sales.

DISCUSSSION

Sales shipped to out-of-state purchasers are normally not considered Indiana sales to be included in the numerator of the sales factor unless (A) the purchaser is the United States Government, or (B) the taxpayer is not taxable in the state of the purchaser, IC § 6-3-2(e)(2). Taxpayer contends that sales "thrown back" to the state of Indiana should not include sales to Kansas, Michigan, and South Carolina because subsequent to the Indiana audit taxpayer was found taxable in these states. The Department concurs.

Taxpayer was taxable in South Carolina. Taxpayer provided a copy of February 14, 1994 correspondence from the South Carolina Department of Revenue and Taxation showing the results of the audit for the period from 1990 to 1992, as well as a copy of taxpayer's 1991 South Carolina Corporation Income Tax Return and taxpayer's 1992 South Carolina Corporation Income Tax Return.

Taxpayer was taxable in Kansas. Taxpayer provided a copy of the June 27, 1996 correspondence from the Kansas Department of Revenue showing the results of the income tax audit for the period from 1991 to 1994, as well as a copy of taxpayer's 1991 Kansas Corporation Income Tax Return.

Taxpayer was taxable in Michigan. Taxpayer provided a copy of a tax statement from the State of Michigan showing substantial taxes to Michigan. The actual incidence of an income tax is not required to avoid the throwback rule. 45 IAC 3.1-1-64 only requires Michigan to have

jurisdiction to subject taxpayer to a net income tax regardless of whether Michigan actually imposes such a tax.

Taxpayer's showing of taxability in the states at issue is sufficient.

FINDINGS

Taxpayer protest sustained.

IV. Adjusted Gross Income Tax– Indiana Research Expense Credit.

DISCUSSSION

Taxpayer provided additional information to support taxpayer's contention that it qualifies for the Indiana Research Expense Credit authorized in IC § 6-3.1-4. Taxpayer provided a copy of its Schedules IT-20REC for the tax years ending in 1991, 1992, and 1993, confirming the amount at issue as a research expense.

FINDINGS

Taxpayer protest is sustained pending audit verification.

V. Adjusted Gross Income Tax– Negligence Penalty

DISCUSSSION

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10. The Indiana Administrative Code further provides:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.
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> (c) The department shall waive the negligence penalty imposed under IC § 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary

> business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
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> (2) judicial precedents set by Indiana courts;
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> (3) judicial precedents established in jurisdictions outside Indiana;
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> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
>
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case. 45 IAC 15-11-2.

Taxpayer requests a waiver of the negligence penalty for report year 1993. Taxpayer presents several arguments in support of waiving the negligence penalty; however, taxpayer has failed to demonstrate that it exercised ordinary business care and prudence in carrying out its duties. The penalty is not waived.

FINDINGS

Taxpayer protest is denied.

JM/PLE/MR 010604